Retail banking market investigation

Prospective entrants

5 June 2015

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the updated issues statement and the other working papers which accompany it. These papers do not form the inquiry group's provisional findings. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional findings, which are currently scheduled for publication in September 2015, taking into consideration responses to the consultation on the updated issues statement and the working papers. Parties wishing to comment on this paper should send their comments to retailbanking@cma.gsi.gov.uk.

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The Competition and Markets Authority has excluded from this published version of the working paper information which the Inquiry Group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂].

Contents

Case studies

In previous investigations we have found that case studies on market entry and expansion can provide powerful insights into the practical difficulties that firms may face trying to enter and/or expand into particular markets. Such studies have contributed to the identification of possible adverse effects on competition and where appropriate have helped us to develop remedies designed to remove or lower barriers to entry or expansion.

We have undertaken six case studies looking at examples of entry and expansion in the provision of personal current accounts (PCAs) and retail banking services to small and medium-sized enterprises (SMEs). We have in addition obtained information on a number of prospective new entrants in the process of seeking bank authorisation. The value of each case study lies in its ability to provide a detailed understanding of the way particular types of event unfold. They are therefore written as factual accounts of events.

We are publishing each case study as a separate working paper and each case study will inform our assessment of barriers to entry and expansion. We are also publishing separate working papers pulling together the evidence from the case studies and from other sources on potential barriers to entry and expansion. The first such working paper – Barriers to entry and expansion: regulation, IT systems and payments systems – will be published shortly and a further working paper on branches will be published in due course. Our updated issues statement published on 21 May 2015 sets out our current general thinking on barriers to entry and expansion.

CMA commentary

1. In the last two years there has been a sharp increase in the number of firms seeking authorisation to provide banking services. This paper describes, in tabular form, the experience of five prospective new entrants that are either in the process of seeking authorisation or that have recently been authorised. None of them has currently begun trading, limiting the level of detail available on performance.

2. The fact that new entry into the retail banking market appears to be accelerating should not be taken to indicate that there are no obstacles to entry in the sector. Clearly, entry and expansion demonstrate that there are no insurmountable barriers but there may well be features of a market that limit the scale, scope and speed of entry and expansion. We note that the companies whose experience we describe here appear to have altered their propositions and operating models to account for some of these features.

3. Based on the views of the companies included in this paper, along with our observations of where they have adapted their business model, there appear to be a number of potential barriers which they have encountered/expect to encounter:

   (a) **Customer inertia:** The prospective entrants generally believe that this is largely down to a lack of differentiation in the existing offerings, which results in apathy from customers. However, even with their new models, the prospective entrants are aware of the risk from continued customer inertia. Many have designed their customer acquisition strategy to address this; for example, Fidor intends to first build an online community of financially interested consumers, and then over time convert these individuals to customers. We also note that even the perception of customer inertia may be a sufficient impediment to deter some prospective entrants.

   (b) **Physical presence/branches:** Launching a new branch network is acknowledged by some as prohibitively expensive, and none of the prospective entrants is doing so. However, they all acknowledge that cash/cheque handling is generally important (and vital for current accounts) so are relying on agency agreements with existing banks to use their branches. Alternatives do exist, for example the Post Office, but these appear to be considered inadequate due to issues with identifying customers and ability to handle larger cash sums.

   (c) **Capital holdings requirements:** Respondents gave mixed opinions on whether capital holding requirements represented a barrier to entry, which

we note may be related to the products they are intending to offer. The specific area mentioned regarded the methodology for risk-weighting assets (RWA). It is important to note that, even if the standard RWA methodology (which new entrants are required to use) and the internal risk based approach (IRB) result in similar holding requirements at a total level, any mismatch on specific products may present a barrier to entering these segments.

4. It is also interesting to note a number of specific areas which appear to present lower barriers than might be expected:

   (a) **Access to payment systems:** The prospective entrants highlighted that access to Faster Payments (specifically) is often key for a compelling proposition and could potentially present a significant barrier. They believe that agency agreements have a number of issues, including cost, speed (real time vs near real time), and whether some information is stripped out. However, we note a recent announcement from Faster Payment Scheme Limited (FPSL) and the Payment Systems Regulator (PSR)[1] that it intends to develop an independent technical direct access solution. This would allow direct access for all market participants which may address the issues discussed, if it is implemented well.

   (b) **Licence application process:** Recent changes to the licence application process including the introduction of the 'authorised with restrictions' have greatly reduced the barriers to entry. The process is not without challenges, but most prospective entrants believe that this is proportionate to the level of responsibility necessary to be a bank.

   (c) **IT platform:** IT costs for start-ups are substantially lower than they are for existing banks due to the latter's high costs of maintaining legacy systems. In addition to this, the introduction of off-the-shelf SaaS IT solutions has resulted in a lower proportion of fixed costs and higher levels of scalability. This results in relatively low barriers to entry for new start-up entrants.

5. Overall, prospective entrants are optimistic about their ability to enter the retail banking market. However, there are some concerns with regards to subsequent expansion; in particular, online-only banks' penetration of the market will be limited by the requirement of some customer segments for certain branch/counter services, especially the ability to deposit cash.

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[1] FPSL announcement, 11 May 2015.

Company views on barriers

Table 1: Summary of views on barriers to entry for prospective entrants

	Atom	*Fidor*	*Starling*	*OakNorth*	*CivilisedBank*
Brief description of company	Digitally led, full service for personal and SMEs	German-based bank offering online financial service platform (including PCAs), with other services through connected third party partners	Offering online PCAs only	SMEs (No BCA) focus, with a digital proposition extending across SMEs and personal deposits	Branchless, relationship-led (bank managers) for SMEs, including BCAs with small digital personal proposition
Potential barriers					
Customer inertia	Primary concern is consumer perception of the industry, which may be hard to change. However, novel propositions may help address this	Community-based model is intended to result in a conversion funnel over time	PCAs currently treated as commodities, so unsurprising customers don't switch as can only compete on price	Major potential barrier, particularly due to existing banks using current accounts to lock in customers, and propensity to buy or 'kill' any significant new competitors. Also, limited credit information compared with the existing bank who has current account data	Certainly a concern, particularly if existing banks are artificially increasing barriers to transfers (eg high costs for break clauses), although some anecdotes which imply may not be too hard to address
Physical presence (eg branches)	No concern as using a competitor to provide	The UK uses relatively little cash (vs Germany), so not intending to launch with any physical branches	Necessary for proposition, so using a competitor to provide	Believes barriers are vast to build your own, and reticent from partnering, so prevents OakNorth from offering a BCA (cash handling)	Necessary to handle cash and cheques, using a competitor to provide
Capital holding requirements (and RWAs)	RWA methodology may disadvantage new start-ups in some areas	No concern as meeting requirements in Germany already	Not mentioned	Capital requirements for operating risk charge is penal for new start-ups due to forward-looking 3 years calculation methodology	No concern
Access to payment systems	Have to use an agency agreement which results in inability to offer real-time processing	Takes time, and sponsor banks have understandably high compliance requirements even for 'safe' European regulated banks. Different from centralised continental Europe system	Very concerned previously due to cost and loss of information from using an agency agreement. Recent changes by PSR should address this	A major barrier to transactional banking	Access to Faster Payments is key and was a concern until the recent announcement. If this is successful, no concerns

	Atom	*Fidor*	*Starling*	*OakNorth*	*CivilisedBank*
Licence application	No concern with regulator, but very difficult to manage capital over an unclear timetable. Similarly, capital allocation becomes more difficult, particularly when needing to commit to third party suppliers	No concern as operating on EU passport. FCA and PRA were very helpful with this	No concern since improvements implemented	The costs, time, and uncertainty of the process is a barrier. However, the barrier is appropriate given retail deposits are being taken	Significant improvements made to process means fine so far, with slight concern it may become more opaque once submitting formal documents
IT systems	Had to find the right partner	No concern as using existing German platform	No concern – multiple options available. Starling is using a combination of package software and bespoke build for [✂]	Regulatory concerns when using a new provider, particularly when proposing more innovative or recent developments (eg use of cloud computing)	No real concerns. Intending to spend [✂], which is significantly less than existing banks would need
Marketing costs	No concern, [✂]	No concern, as based on building a community then converting community members interested in retail banking products. [✂]	Business model requires scale, so allocating [✂]	Not mentioned	No concern as largely based on word of mouth via social media, with small amounts of central spend
Ongoing regulatory burdens	Not mentioned	Not mentioned	Not mentioned	Concerned about the next step of growth, in particular if political support of new entrants is withdrawn, then regulator could introduce severe ongoing burdens	Not mentioned
Staff recruitment	Not mentioned	No concern as London labour pool is entrepreneurial and well qualified	Not mentioned	Finding senior staff who have the start-up mentality is difficult, as people with experience have largely worked in large banks	No concern with finding bank managers for launch
Initial funding	Not mentioned	Not mentioned	Not mentioned	Not mentioned	Regulatory risk pre-application is difficult to manage, particular with PE/VC-type investors who are used to greater levels of control

	Atom	*Fidor*	*Starling*	*OakNorth*	*CivilisedBank*
KYC/AML	Not mentioned	No concern, and actually part of business model as ensures consumers are KYC/AML approved for its financial services partners	Not a concern, since existing banks' processes are not optimally implemented. More effective processes can be delivered using more customer friendly technology	Not mentioned	Not concerned, and investigating how detailed actually needs to be as existing bank may be overly stringent
Geographic coverage	No concern	Not mentioned	No concern	No concern	No concern as lack of geographical overhead allows a gradual rollout, testing new areas

Source: Interviews with companies, regulatory business plans, investor presentations and CMA analysis.